

# The US should not roll back financial regulation



*The Dodd-Frank Act is not perfect, but it's a framework that can mitigate systemic risks, writes [Markus Demary](#).*

In the United States, the House of Representatives has passed the [Financial CHOICE Act](#) (Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs Act). This bill is intended to replace the financial market regulation of the Obama era, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was a response to the global financial market crisis of

2008.

One of the cornerstones of Dodd-Frank was the macroprudential view, i.e. the system-wide view on financial markets. It addresses the interconnections of market participants, the possibility of herding behaviour and the build-up of credit and asset price bubbles. In contrast to this, the Financial CHOICE Act goes back to the microprudential view, i.e. its focus is on the risks of isolated financial institutions.

The disadvantages of the Financial CHOICE Act over Dodd-Frank can be seen from [the following examples](#):

## Regulatory relief for well-capitalised banks

The Financial CHOICE Act allows banks with an unweighted equity-capital ratio (leverage ratio) of more than 10 per cent to switch to a less stringent regulatory framework than Basel III, which the act calls capital election. An equity capital ratio of more than 10 per cent appears to be high from a European perspective. However, it must be taken into account that the balance sheets of US banks are smaller than the balance sheets of comparable European banks due to different accounting rules. The capital election is based on the assumption that highly capitalized banks should be able to cover their losses without the intervention of supervisory authorities.

This approach neglects the effects of herding behaviour on the financial system's stability as well as the possibility of concentration risks in banks' balance sheets. Basel III addresses these risks with instruments such as the anti-cyclical capital buffer and the sectoral risk weights.

## Bank resolution through the bankruptcy code

The Financial CHOICE Act will abate the Orderly Liquidation Authority (OLA). Instead, banks in a state of emergency should be resolved via the Bankruptcy Code. The OLA was established on the basis of the experience of the global financial market crisis when it proved almost impossible to resolve large investment banks through the normal insolvency framework.

In a normal insolvency proceeding, the creditors decide in a judicially monitored process on the recovery of assets. Any necessary pre-financing of resolution measures is made through the sale of assets of the failed company.

The bankruptcy code might be suitable for the resolution of smaller banks, but it is not suitable for the resolution of larger investment banks. In the case of the failure of a large investment bank, repercussions and contagion effects on the financial system must be expected. These negative effects result on the one hand from the very short maturities of the liabilities of an investment bank, so that the freezing of these liabilities can cause liquidity shortages among the creditors and cause disruptions in the entire payment system. On the other hand, negative effects result from the sale of assets on a large scale, which causes price pressure on comparable assets that cause mark-to-market losses for other banks.

It is therefore damaging to the financial system to bring the so-called system-relevant functions of a large bank in an insolvency process to a halt. Instead, these critical functions must be stabilized in an orderly process over a long period of time. This is why the OLA is set up.

The abatement of the OLA by the Financial CHOICE Act carries the risk that, as in the case of Lehman Brothers, the unordered insolvency of an investment bank can lead the financial system to collapse. This would also lead to a loss of European banks through the global interconnections of the banks.

## Abatement of the Volcker rule

The Financial CHOICE Act will abolish the Volcker rule, which restricts the financing of proprietary trading with insured deposits and for banks with access to the Federal Reserve's discount window.

The Volcker rule can be seen very critically. On the one hand, the banks' proprietary trading is not exactly distinguishable from trading on behalf of customers. This would be the case if, in preparation for a customer order to hedge price fluctuations, a bank initially acts on its own account. On the other hand, the Volcker rule does not distinguish between proprietary trading and market-making activities.

Through the abatement of the Volcker rule there is the risk that trading from the EU could shift to the then possibly less regulated US.

## Reducing consumer protection

The Financial CHOICE Act abates the Fiduciary Rule, which obliges providers of pension products to work in the best interest of the customer. The Fiduciary Rule is not part of Dodd-Frank, but it was decided at the same time. In addition, the Financial CHOICE Act will limit the independence of the Consumer Financial Protection Bureau (CFPB), which will be restructured. The CFPB will be prohibited to publish any consumer complaints about financial products or the suppliers of these products.

Although the reduction of consumer protection can improve household access to financial products, it must also be taken into account that, in the pre-crisis period, the lack of consumer protection in the US stimulated the lending to households with low credit ratings, which contributed to the emergence of the US real estate bubble.

## The Financial CHOICE Act lacks system view

The Financial CHOICE Act may be conclusive in some respects from the micro-prudential point of view. However, it neglects the macroprudential view. Even though the Dodd-Frank Act was not perfect in all respects, it represents a framework that can mitigate systemic risks.

The fact that financial market regulation is adjusted from time to time is normal. Some regulations are no longer up-to-date because they are based on obsolete technical standards or because they are too loosely or too strictly defined. Instead of rolling back Dodd-Frank, Democrats and Republicans would have better strived for improving the disadvantages of the Dodd-Frank Act without sacrificing its advantages over the pre-crisis regulatory framework.

*This article originally appeared at the [LSE Business Review](#).*

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